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ALEXANDER L. STEVAS,
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80-1468

No. .....

IN THE

Supreme Court of the United States

OCTOBER TERM, 1980

BARRY L. BATTELSTEIN
AND JERRY E. BATTELSTEIN,

Petitioners,

v.

INTERNAL REVENUE SERVICE,

Respondent.

ON WRIT OF CERTIORARI TO THE
UNITED STATES COURT OF APPEALS
FOR THE FIFTH CIRCUIT

PETITION FOR CERTIORARI

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QUESTION PRESENTED

Whether a cash basis taxpayer who pays for a deductible item by check is entitled to a deduction for such item in the year the check was given.[1]

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[1] The caption of the case in this Court contains the names of all parties to the proceeding in the court whose judgment is sought to be reviewed.

TABLE OF CONTENTS

	Page
Question Presented	i
Table of Contents	ii
Table of Authorities	ii
Opinions Below	1
Statement of Jurisdiction	2
Statutes Involved	2
Statement of the Facts	2
Reasons for Granting the Writ	3
Appendix	A-1

TABLE OF AUTHORITIES

Statutes

26 U.S.C.A. § 163(a) 2

Cases

Burck v. *Commissioner*, 63 T.C. 556 (1975), *aff'd on other grounds*, 533 F.2d 768 (2d Cir. 1976) 4, 8, 9, 10

Newton A. Burgess, 8 T.C. 47 (1947) 8, 9, 10

Clark v. *Commissioner*, 253 F.2d 745 (3d Cir. 1958) 5, 6

Cleaver v. *Commissioner*, 6 T.C. 452, *aff'd*, 158 F.2d 342 (7th Cir. 1946), *cert. denied*, 330 U.S. 849 (1947) 8

Commissioner v. *Bradley*, 56 F.2d 728 (6th Cir. 1932) 5

Estate of Spiegel v. *Commissioner*, 12 T.C. 524 (1949) 5

Goodstein v. *Commissioner*, 30 T.C. 1178, *aff'd*, 267 F.2d 127 (1st Cir. 1959) 8

Gregory v. *Helvering*, 293 U.S. 465 (1935) 8

Heyman v. *Commissioner*, 70 T.C. 482 (1978) 9

Robert B. Keenan, 20 B.T.A. 498 (1930) 7

	Page
Keith v. *Commissioner* 139 F.2d 596 (2d Cir. 1944)	8
Knetsch v. *United States*, 364 U.S. 361 (1960)	8
Lee v. *United States*, 571 F.2d 1180 (Ct. Cl. 1978)	7
Hazel B. McAdams, 15 T.C. 231 (1950), *aff'd*, 198 F.2d 54 (5th Cir. 1952)	7
Nat Harrison Associates, Inc. v. *Commissioner*, 42 T.C. 601 (1964)	8
Rubnitz v. *Commissioner*, 67 T.C. 621 (1977)	8, 9
Wilkerson v. *Commissioner*, 70 T.C. 240 (1978)	8, 9, 10
Don E. Williams Co. v. *Commissioner*, 429 U.S. 569 (1977)	6

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ON WRIT OF CERTIORARI TO THE
UNITED STATES COURT OF APPEALS
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PETITION FOR CERTIORARI

The Petitioners, Barry L. Battelstein and Jerry E. Battelstein, respectfully pray that a writ of certiorari issue to review the judgment of the United States Court of Appeals for the Fifth Circuit entered in this proceeding on December 3, 1980.

OPINIONS BELOW

The opinion of the United States Court of Appeals for the Fifth Circuit on rehearing en banc, reported at 631 F.2d 1182, appears in the Appendix at p. A-1. The opinion of

the Court of Appeals, reported at 611 F.2d 1033, appears in the Appendix at p. A-15. The order of the United States District Court for the Southern District of Texas (Houston Division), not reported, appears in the Appendix at p. A-29. The opinion of the United States District Court for the Southern District of Texas (Bankruptcy Division), reported at 77-2 U.S.T.C. § 9516, appears in the Appendix at p. A-33.

JURISDICTION

The United States Court of Appeals for the Fifth Circuit entered its judgment on February 14, 1980 and, after granting Petitioners' motion for rehearing en banc, vacated such judgment and entered final judgment on December 3, 1980. Petitioner invokes this Court's jurisdiction under 28 U.S.C. Sec. 1254.

STATUTORY PROVISIONS INVOLVED

26 U.S.C.A. (Internal Revenue Code) Section 163(a) provides:

> There shall be allowed as a deduction all interest paid or accrued within the taxable year on indebtedness.

STATEMENT OF THE FACTS

Petitioners are cash-basis taxpayers. On January 27, 1971, Petitioners and two persons not parties to this action entered into a loan agreement with Gibraltar Savings Association. In the loan agreement, Gibraltar agreed to lend Petitioners the funds necessary to purchase a certain tract of land in Houston, Texas, and to extend future loans to Petitioners to reimburse them for the expenses required to retain and maintain the tract until utilities became available and development was both possible and feasible. Such

future loans were to be evidenced by new notes at a rate of interest different from that of the original loan. Memorandum opinion at A-35.

In 1973, 1974 and 1975 Petitioners and Gibraltar entered into additional loans at a higher interest rate than the initial note and with different maturity dates, each loan in an amount equal to the amount of interest or taxes paid for the tract. Upon notice from Gibraltar that an interest payment on the original loan was due, Petitioners would send Gibraltar their checks for the interest payment. At the time of each interest payment, Petitioners had assets more than sufficient to cover the payment. *Id.* at A-35, A-38, A-39. Petitioners would request that Gibraltar lend them funds to reimburse for the interest payments, as well as for the ad valorem taxes, and Gibraltar would comply. Each Petitioner deposited the additional loan proceeds into his general business account at an institution other than Gibraltar, with the result that the loan proceeds became commingled with funds in that account. Gibraltar had no control over the funds loaned to Petitioners. *Id.* at A-35. Gibraltar generally held Petitioners' checks until it had issued its check to Petitioners.

Petitioner Barry L. Battelstein filed a Chapter XI Petition under the Bankruptcy Act on November 1, 1976; Petitioner Jerry E. Battelstein filed a Chapter XI Petition under the Bankruptcy Act on April 1, 1977. This case arose from Petitioners' objections to claims filed by the Internal Revenue Service. The cases were consolidated and tried before the Bankruptcy Court of the United States District Court for the Southern District of Texas. The bankruptcy court found that Petitioners had paid interest on the original loan from Gibraltar and qualified for the interest deduction under the Internal Revenue Code of 1954. *Id.* at A-39, A-41. The court ordered that the claim against Peti-

tioner Barry L. Battelstein be reduced and that the claims against Petitioner Jerry E. Battelstein be denied.

The United States District Court for the Southern District of Texas affirmed the bankruptcy court's holdings on August 29, 1977. The United States Court of Appeals for the Fifth Circuit reversed the District Court's decision on February 14, 1980 and vacated its opinion upon granting Petitioners' request for rehearing en banc on April 11, 1980. On December 3, 1980, the United States Court of Appeals for the Fifth Circuit reversed the decision of the district court by a vote of 14 to 10 and remanded the cause for determination of tax liability. Petitioners filed this petition for a writ of certiorari within ninety days from the date of entry of judgment upon rehearing.

REASONS FOR GRANTING THE WRIT

1. The decision of the Fifth Circuit conflicts with a decision of the Second Circuit.

In *Burck* v. *Commissioner,* 533 F.2d 768 (2d Cir. 1976), *aff'g* 63 T.C. 556 (1975), the Second Circuit allowed the taxpayer to take a deduction for interest paid under circumstances similar to those of Petitioners. The taxpayer had placed funds borrowed from a Michigan bank into his New York bank account and, one day later, transferred funds to the Michigan bank as a payment of interest. The court disallowed the portion of the claimed deduction for interest attributable to the succeeding taxable year. Because the trial court had found the loan to be a valid transaction, rather than a sham, the Second Circuit upheld the deduction for prepaid interest that accrued in the taxable year. Similarly, Petitioners commingled the loan proceeds with their general funds and made interest payments from their general accounts. In the instant case, the bankruptcy court, affirmed by the district court, specifically

found that the loan transactions were not a sham, but arose from valid business purposes. Memorandum opinion at A-39. Disregarding the Second Circuit's treatment of similar circumstances, the Fifth Circuit has responded to the situation of interest payments from borrowed funds with the opposite result. The Fifth Circuit's decision has resulted in the availability of a deduction for interest depending on geography; taxpayers in the Second Circuit may take one, but those in the Fifth Circuit may not. This conflict and disparity in treatment of taxpayers justify the grant of certiorari to review the judgment below.

2. The Fifth Circuit has decided an important question of federal law that has not been, but should be, settled by this Court.

The question of federal law raised by the Fifth Circuit's decision is important for three reasons:

(1) the decision conflicts with the principle that a check constitutes payment for tax purposes at the time of delivery if the check is honored upon presentment;

(2) the decision is contrary to a long-standing tax law precedent and its progeny; and

(3) the decision will affect both commerce and a substantial number of cash-basis taxpayers.

First, the decision of the Fifth Circuit is contrary to the maxim that a check, so long as ultimately honored, is the equivalent of cash for tax purposes. *See, e.g., Clark* v. *Commissioner,* 253 F.2d 745 (3d Cir. 1958); *Commissioner* v. *Bradley,* 56 F.2d 728 (6th Cir. 1932); *Estate of Spiegel* v. *Commissioner,* 12 T.C. 524 (1949) (citing cases). This maxim is a corollary of the general rule of law, codified in Section 3-802 of the Uniform Commercial

Code, that payment by check occurs at the time of delivery if the check is honored upon presentment.

The federal courts usually equate the giving of a check with payment by cash because from a practical standpoint the consequences of the actions are the same. By writing a check a taxpayer does not merely promise to pay.[1] Such a taxpayer has instructed his bank to transfer funds out of his account. He has conditionally paid; his obligation to pay becomes suspended until the drawee bank honors the check and payment becomes final. Recognizing the common practice of paying by check, the federal courts have therefore treated an ultimately honored check as the equivalent of cash with few exceptions, such as the giving of a check in one year with the agreement that it not be cashed until the next. *Clark* v. *Commissioner,* 253 F.2d 745 (3rd Cir. 1958). The case of Petitioners does not present such an exception to the general treatment of payment by check. At the time of the interest payments, Petitioners sent Gibraltar their checks. By executing the checks, Petitioners instructed their banks to transfer money out of their accounts, regardless of whether Gibraltar extended additional loans. The bankruptcy court found that in some instances the funds on deposit in Petitioners' accounts when Gibraltar received the checks were already sufficient to cover the checks. Memorandum opinion at A-35. The dissent to the en banc opinion noted that in some instances

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[1] A promise to pay does not constitute payment for tax purposes. *See, e.g., Don E. Williams Co.* v. *Commissioner,* 429 U.S. 569 (1977). It should be noted that the following statement in the majority opinion in the court below is incorrect: "What happened at the time of each of the exchanges, as the Battelsteins now concede, is that the Battelsteins gave Gibraltar their note promising to pay the amount of interest then due, plus interest in the future." En banc opinion at A-2. Petitioners conceded no such thing. They promised to pay in the future an amount equal to what they borrowed plus interest.

the check to Gibraltar was debited before the proceeds from the additional loan were deposited. 631 F.2d at 1188, reprinted herein at A-13. On the occasions that the funds on deposit were insufficient to cover the interest checks, Petitioners would have been obligated to honor the checks out of their substantial assets, in the event that Gibraltar had declined to lend a requested amount. The trial court found that Petitioners paid interest by checks. Memorandum opinion at A-39. The Fifth Circuit rejected both this finding and the general rule regarding payment by check. The Fifth Circuit's decision calls into question the treatment of a check as the equivalent of cash and creates a new exception to the general rule: a check honored upon presentment does not constitute payment at the time of delivery if the payor has deposited funds received from the payee in the account upon which, and during the year in which, the check is honored. The decision of the Fifth Circuit confuses a once-clear area of the tax law for the taxpayers in the Circuit.

Second, the Fifth Circuit's decision conflicts with a body of holdings by the Tax Court. The Tax Court has long held that a deduction is not disallowable merely because the contested item was paid with borrowed funds. In *Hazel B. McAdams,* 15 T.C. 231 (1950), *aff'd,* 198 F.2d 54 (5th Cir. 1952), the Tax Court found that expenses paid with borrowed funds are deductible by a cash-basis taxpayer in the year in which they are paid. The Tax Court followed its reasoning in an earlier case, *Robert B. Keenan,* 20 B.T.A. 498 (1930). The Court of Claims recognized the irrelevance of the source of funds for payment in *Lee* v. *United States,* 571 F. 2d 1180 (Ct. Cl. 1978), in which it noted that the mere source of a loan should not affect the deductibility for income tax purposes of interest paid on the loan. The Fifth Circuit's decision in the instant case, however, pivots on the source of the loan.

By disallowing Petitioners' deductions, the Fifth Circuit has reached a result opposite to the response of the Tax Court to similar situations. The Tax Court has in numerous cases evaluated the payment of interest to a lender with funds borrowed from such lender. When the lender, without disbursing the entire loan proceeds to the taxpayer-borrower, applies a portion of the loan to interest due on a previous loan, the Tax Court has held that interest has not been paid. *Rubnitz* v. *Commissioner,* 67 T.C. 621 (1977); *Nat Harrison Associates, Inc.* v. *Commissioner,* 42 T.C. 601 (1964); *Cleaver* v. *Commissioner,* 6 T.C. 452, *aff'd,* 158 F.2d 342 (7th Cir. 1946), *cert. denied,* 330 U.S. 849 (1947); *Keith* v. *Commissioner,* 139 F.2d 596 (2d Cir. 1944). The Tax Court has also denied the interest deduction when the underlying transaction was a sham designed to avoid taxation. *Goodstein* v. *Commissioner,* 30 T.C. 1178, *aff'd,* 267 F.2d 127 (1st Cir. 1959); *see also Knetsch* v. *United States,* 364 U.S. 361 (1960); *Gregory* v. *Helvering,* 293 U.S. 465 (1935).[2] The Tax Court has, however, consistently found that a taxpayer did pay interest in cases similar to the instant case: *Newton A. Burgess,* 8 T.C. 47 (1947); *Burck* v. *Commissioner,* 63 T.C. 556 (1975), *aff'd on other grounds,* 533 F.2d 768 (2d Cir. 1976); and *Wilkerson* v. *Commissioner,* 70 T.C. 240 (1978). In *Burgess,* the taxpayer's actions paralleled those of Petitioners. Having entered into two loans with a lender, the taxpayer borrowed additional funds from the lender nine days before making interest payments on the previous loans. At the time of the third loan, the taxpayer executed a new promissory note and deposited the loan proceeds in his general unrestricted bank account. The cash from the loan proceeds thus became commingled with the taxpayer's other funds and lost its identity. The Tax Court allowed the deduction for interest.

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[2] The majority opinion on rehearing did not disturb the bankruptcy court's finding that Petitioners' transaction was not a sham, but was for valid business purposes.

It reached the same conclusion in *Burck*. Refining its decision in *Burgess*, the Tax Court in *Burck* based the allowance of the deduction primarily on four factors: (1) the existence of valid and legitimate reasons for the second loan other than the repayment of interest on the first loan, so that the transaction was not a sham; (2) the commingling of borrowed funds with the taxpayer's general account which destroyed the identity of the borrowed funds, so that the interest payment could not be traced to the loan; (3) the availability of other assets from which the interest payment could have been made, so that the second loan was not required for the taxpayer to pay the interest; and (4) the lack or loss of control of the loan proceeds by the lender. The Tax Court has reiterated the factors established in *Burck* and *Burgess* in subsequent cases. The absence of one or more factor led the Tax Court to find that interest was not paid in *Rubnitz* v. *Commissioner*, 67 T.C. 621 (1977) and *Heyman* v. *Commissioner*, 70 T.C. 482 (1978). Because the factors of *Burgess* and *Burck* were present, the Tax Court held that the taxpayers had paid interest by check in *Wilkerson*, even though most of the funds in the account on which the check was drawn originated from the lender to whom the check was given.

The bankruptcy court in the instant case found all four factors present in Petitioners' loans from Gibraltar. The first factor, a valid business purpose, arose out of the need to finance a multimillion dollar long-range venture. Memorandum opinion at A-39; see also the dissent to the en banc opinion at A-11. The bankruptcy court recognized the presence of the second factor in Petitioners' pattern of placing proceeds from the second loans in their unrestricted general business accounts at institutions other than Gibraltar. Memorandum opinion at A-39. The third factor is apparent from the bankruptcy court's finding that at the

time of each challenged interest payment, Petitioners had assets sufficient to cover the payment and, on some occasions, already had enough funds on deposit to cover the checks. *Id.* at A-35, A-39. Finally, the bankruptcy court pointed to the existence of the fourth factor in the absence of restrictions by Gibraltar on the use of the loan proceeds. *Id.* at A-35. Although the bankruptcy court in the instant case found all factors to be present in Petitioners' loan transactions, the Fifth Circuit chose to disregard the findings, as well as the Tax Court's holdings in *Burgess, Burck* and *Wilkerson.* The conflict between this decision by the Fifth Circuit and the holdings of the Tax Court presents further opportunity for inconsistent treatment of taxpayers.

Third, the question raised by the Fifth Circuit's decision is important because of the effect that it will have on commerce and a large number of taxpayers. An analogy to contract law points out the importance of the question posed by the Fifth Circuit's decision. Contract law has developed to facilitate, not to hinder, commerce; to promote trade rather than to set traps and pitfalls. This goal was accomplished by encouraging reliance on the sanctity of the contract through consistent treatment of similar situations. The tax laws, of course, serve a different purpose — collecting revenue for the government. Because their impact is a factor that must be considered in most significant business decisions, the tax laws also serve the purpose of shaping commerce. In fulfilling these purposes, however, the tax laws must ultimately be based on the same principles as those that underlie contract law. The application of the tax laws should not thwart commerce by creating uncertainty in the tax consequences of legitimate transactions, and thus of the taxpayer's cash flow; such an effect could only diminish sources of revenue. The government should apply

the tax laws consistently to similar types of transactions so long as they are not a sham. Businessmen such as Petitioners form their enterprises in reliance on the tax laws and their longstanding interpretation by the courts. Petitioners are cash-basis taxpayers, as are the overwhelming majority of all U.S. taxpayers, and must therefore report their income in the year received and take deductions for items in the year paid. As the bankruptcy court, the trier of fact, found, the transaction was not a sham but rather based on the valid business purposes of acquiring and holding a valuable piece of land until it could be developed. As land developers, Petitioners purchased the tract not simply to extract a tax benefit, but for the obvious purposes of developing the land and making a profit. In two of the years in question, Petitioner Barry Battelstein did not take a deduction for interest but instead capitalized it. The Fifth Circuit has now penalized Petitioners for their business ventures. The position of the Internal Revenue Service and the decision of the Fifth Circuit harms not only Petitioners but countless other cash-basis taxpayers at all income levels. A hypothetical similar to that posed by Judge Politz, speaking for the ten dissenters in the Fifth Circuit's en banc opinion at A-9, vividly demonstrates the effects. Posit a taxpayer who has monthly home mortgage payments owed to the same lending institution at which he keeps his checking account. As is becoming increasingly common, the hypothetical taxpayer has overdraft protection, an automatic line of credit with his bank. Although the taxpayer has assets he could liquidate, occasionally he may rely on his line of credit and essentially borrow money from his bank, the same bank to which he owes interest on his mortgage. Because of the possibility that funds drawn on the line of credit may have been used, the Fifth Circuit's decision will call into question the deductibility of the hypothetical taxpayer's mortgage payments.

The effect of the Fifth Circuit's decision will be to further complicate and discourage commerce. Taxpayers who pay interest to a lender and wish to take a loan in the same year must now seek out a second lender to avail themselves of the interest deduction. The Fifth Circuit's decision rests solely on the source of the second loan. If allowed to stand, the decision below will deter knowledgable taxpayers from contracting with their existing lenders and will be a trap for the unwary. It will discourage, if not punish, those taxpayers who borrow from a lender an amount at least equal to sums paid to such lender in the same year. A multitude of cash-basis taxpayers, from sophisticated entrepreneurs to homeowners, will suffer from this decision. Those who have financial power or a banking relationship with more than one financial institution will be able to secure needed loans from a second lender and thus qualify for the interest deduction; those who do not, or who are not aware of the peculiar distinction established by the Fifth Circuit, will not.

The Internal Revenue Service, the Congress and the courts have consistently recognized the right of taxpayers who effect transactions having a significance independent of tax consequences to utilize the benefits available under the tax laws to reduce or postpone their tax liability. Often these involve the timing of a deduction, as in the instant case. Examples of such transactions are legion. Among them are an accrual basis corporation declaring a bonus to a cash basis employee on December 31 of one year, taking the deduction in the year the bonus was declared and paying the bonus on January 1 of the following year so that the employee reports the income in the following year, the year in which he received the payment. Another example is that of the taxpayer who, after reviewing his income and deductions for a year, chooses to make sales of stock in the last few days of the year, sometimes at a loss to offset gains

taken earlier in the year, or sometimes at a profit to offset losses which have been taken earlier in the year. The majority in the en banc opinion raised the spectre that the independent significance of transactions will be disregarded, for the majority in the en banc opinion, unlike the panel majority, did not disregard the bankruptcy court's finding that there was no sham. Thus, they have created, as the dissent points out, a "legal minefield". En banc dissent, at A-8.

CONCLUSION

For these reasons, a writ of certiorari should issue to review the judgment and opinion of the Fifth Circuit.

Respectfully submitted,

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APPENDIX A-1

BARRY L. BATTELSTEIN
and JERRY E. BATTELSTEIN,
Plaintiffs-Appellees,

v.

INTERNAL REVENUE SERVICE,
Defendant-Appellant,

No. 77-3212.

UNITED STATES COURT OF APPEALS,
FIFTH CIRCUIT.

Dec. 3, 1980

Cash basis taxpayers filed Chapter XI bankruptcy petition. The bankruptcy judge denied claims filed by the Internal Revenue Service. The United States District Court for the Southern District of Texas, John V. Singleton, Jr., Chief Judge, affirmed, and the Service appealed. The Court of Appeals, Frank M. Johnson, Jr., Circuit Judge, 611 F.2d 1033, reversed and remanded. After granting taxpayers' petition for rehearing en banc, the Court of Appeals, Frank M. Johnson, Jr., Circuit Judge, held that cash basis taxpayers were not entitled to interest deduction in connection with lender's advances of interest costs facilitated by means of exchanges of checks between taxpayers and lender and by taxpayers executing notes for amount of interest due.

Reversed and remanded for calculation of tax liability.

Politz, Circuit Judge, dissented and filed opinion in which Brown, Roney, Gee, James C. Hill, Fay, Vance, Garza, Reavley and Randall, Circuit Judges, joined.

Internal Revenue — 518

Cash basis taxpayers were not entitled to interest deduction in connection with lender's advances of interest costs facilitated by means of exchanges of checks between taxpayers and lender and by taxpayers executing note for amount of interest due. 26 U.S.C.A. § 163(a).

Appeal from the United States District Court for the Southern District of Texas.

Before COLEMAN, Chief Judge, BROWN, AINSWORTH, GODBOLD, CHARLES CLARK, RONEY, GEE, TJOFLAT, HILL, FAY, RUBIN, VANCE, KRAVITCH, FRANK M. JOHNSON, Jr., GARZA, HENDERSON, REAVLEY, POLITZ, HATCHETT, ANDERSON, RANDALL, TATE, SAM D. JOHNSON, and THOMAS A. CLARK, Circuit Judges.

FRANK M. JOHNSON, Jr., Circuit Judge:

This case arose out of Chapter XI petitions in bankruptcy filed by Barry L. Battelstein and Jerry E. Battelstein in the United States District Court for the Southern District of Texas. In the ensuing proceedings, the Internal Revenue Service (IRS) filed proof of claims against each. The Battelsteins objected to the claims and their objections were consolidated for trial. The bankruptcy judge denied the IRS claims after trial and the denial was affirmed by the district court. In response to an appeal filed by the IRS, a panel of this Court reversed the district court's decision denying the IRS claims and remanded the case to the district court for a calculation of tax liability. *Battelstein* v. *Internal Revenue Service,* 611 F.2d 1033 (5th Cir. 1980). The panel's decision was vacated when the Court granted the Battelsteins' petition

for rehearing en banc. *Battelstein* v. *Internal Revenue Service,* 616 F.2d 253 (5th Cir. 1980). The case was taken under submission by the Court en banc following additional briefing by the parties.

The facts are not in dispute. As the panel opinion explained, the Battelsteins were land developers. Gibraltar Savings Association was their lender. In 1971, Gibraltar agreed to loan the Battelsteins more than three million dollars to cover the purchase of a piece of property known as Sharpstown. Gibraltar also agreed to make to the Battelsteins, if desired, future advances of the interest costs on this loan as they became due. The Battelsteins never paid interest except by way of these advances. Each quarter, Gibraltar would notify the Battelsteins of the amount of interest currently due. The Battelsteins would then send Gibraltar a check in this amount, and, on its receipt, Gibraltar would send the Battelsteins its check in the identical amount.

The controversy stems from the Battelsteins' deduction of the amount of these checks under authority of Internal Revenue Code § 163(a), 26 U.S.C. § 163(a). Section 163(a) allows cash basis taxpayers such as the Battelsteins to take a deduction for interest paid within the taxable year on indebtedness. The issue in this case is whether the Gibraltar-Battelstein check exchanges resulted in interest being paid within the taxable year. The bankruptcy judge and the district court decided that the exchanges had such a result. We conclude as did the panel, that this decision was incorrect.

It is plain that the check exchanges relied on by the Battelsteins could not themselves extinguish the Battelsteins' interest obligations to Gibraltar. What happened at the time of each of the exchanges, as the Battelsteins now concede, is that the Battelsteins gave Gibraltar their

note promising to pay the amount of interest then due, plus interest, in the future. It is well established, however, that such a surrender of notes does not constitute the current payment of interest that Section 163(a) requires. The Supreme Court has repeatedly held, as long ago as 1931 and as recently as 1977, that payment for tax purposes must be made in cash or its equivalent. *Don E. Williams Co.* v. *Commissioner,* 429 U.S. 569, 577-58, 97 S.Ct. 850, 855-56, 51 L.Ed.2d 48(1977; *Eckert* v. *Burnet,* 283 U.S. 140, 141, 51 S.Ct. 373, 374, 75 L. Ed.911 (1931). See also *Battelstein* v. *Internal Revenue Service,* 611 F.2d at 1035 n.3 (citing additional cases). The 1977 decision explained that, "The reasoning is apparent: the note may never be paid, and if it is not paid, 'the taxpayer has parted with nothing more than his promise to pay.'" *Don E. Williams Co.* v. *Commissioner,* 429 U.S. at 578, 97 S.Ct. at 856. The Battelsteins attempted to avoid such a characterization of their interest transactions here by adding to their surrender of notes the inconsequential exchanges of identical amount checks.[1] In ignoring these exchanges, we merely follow a well established principle of law, viz., that in tax cases it is axiomatic that we look through the form in which the taxpayer has cloaked a transaction to the substance of the transaction. See, e.g., *Republic Petroleum Corp.* v. *United States,* 613 F.2d 518, 524 (5th Cir.1980); *Redwing Carriers, Inc.* v. *Tomlinson,* 399 F.2d 652, 657 (5th Cir.1968) (citing cases). As the Supreme Court stated some years ago in *Minnesota Tea Co.* v. *Helvering,* 302 U.S. 609, 58 S.Ct. 393, 82 L.Ed. 474 (1938), "A given result at the end of a straight path is not made a different result because reached by following a devious path." 302 U.S. at 613, 58 S.Ct. at 394. The check exchanges notwithstanding, the Battelsteins satisfied their

[1] The Battelsteins do not assert, nor do we find it possible to infer, any other purpose for the check exchanges.

interest obligations to Gibraltar by giving Gibraltar notes promising future payment. The law leaves no doubt that such a surrender of notes does not constitute payment for tax purposes entitling a taxpayer to a deduction.

As the panel concluded, the Battelsteins' reliance on the line of Tax Court cases beginning with *Burgess* v. *Commissioner*, 8 T.C. 47 (1947),[2] is misplaced, even assuming that the *Burgess* cases constitute good law. In the *Burgess* cases, the Tax Court was faced with situations in which taxpayers had obtained first one loan and then another from the same lender, and then had attempted to claim a deduction for interest paid on the first loan, even though the interest was possibly paid with funds obtained as part of the second loan. Under the Code, a taxpayer may be entitled to a deduction in such a situation only if the second loan was not for the purpose of financing the interest due on the first loan. If the second loan was for the purpose of financing the interest due on the first loan, then the taxpayer's interest obligation on the first loan has not been paid as Section 163(a) requires; it has merely been postponed.[3] In many cases, it is not apparent what the purpose of a subsequent loan was whether it was to finance the interest payments on a previous loan for which deductions are being claimed,

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[2] In addition to *Burgess*, see *Burck* v. *Commissioner*, 63 T.C. 556 (1975), aff'd on other grounds, 533 F.2d 768 (2d Cir. 1976), and *Wilkerson* v. *Commissioner*, 70 T.C. 240 (1978).

[3] In other words, the obligation as between the taxpayer and the lender remains but like a note promising payment in the future, which does not qualify for a deduction, see supra – merely in another form. Compare the situation in which a taxpayer borrows money from a certain lender, and then borrows money from a third party in order to pay the original lender the interest. In such a situation the interest is considered paid and deductible because the obligation as between the taxpayer and the original lender has not been postponed, it has been extinguished. See, e.g., *Crain* v. *Commissioner*, 75 F.2d 962, 964 (8th Cir. 1935), *McAdams* v. *Commissioner*, 15 T.C. 231, 235 (1950).

or whether it was to fulfill some other unrelated objective. In the *Burgess* cases, the Tax Court attempted to establish a formula to be used in making such a determination.[4] The formula has been subject to criticism for being too easy to manipulate by taxpayers and thus as unduly inviting tax evasion. Whether or not this criticism is valid, it is clear that it is unnecessary to apply the formula here, or that if applied here in light of its purpose it could yield only one result. This is because the subsequent loans made by Gibraltar to the Battelsteins — the checks issued by Gibraltar to the Battelsteins as part of the check exchanges, in the exact amount of the Battelsteins' currrent interest obligations — were plainly for no purpose other than to finance the Battelsteins' current interest obligations to Gibraltar. See note 1, supra. Even under *Burgess,* the Battelsteins' check exchanges cannot be said to have resulted in the payment of interest required for a deduction by Section 163(a).

In announcing our decision, we note that, contrary to what has been suggested, neither the Court nor, for that matter, the panel has considered the Battelsteins' 'entrepreneurial style' to be an issue in this case. For business men to defer payment of interest obligations in the way the Battelsteins have done may well be a sensible way in which to do business. Whether it is or is not, what is relevant here is that interest obligations so deferred cannot be claimed for tax purposes as interest obligations paid.

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[4] In *Burgess* and its progeny, the Tax Court held that interest may be considered paid even though the taxpayer may have paid it with money subsequently borrowed from the initial lender, so long as the money subsequently borrowed actually passed into the hands or bank account of the taxpayer, was commingled with other funds of the taxpayer and thus became subject to the taxpayer's unrestricted control. *Burgess* v. *Commissioner,* 8 T.C. at 49-50. See also *Wilkerson* v. *Commissioner,* 70 T.C. at 257-67; *Burck* v. *Commissioner,* 63 T.C. at 559-60.

Under the Code, cash basis taxpayers such as the Battelsteins are entitled to a deduction for interest paid on indebtedness only if that interest is paid within the taxable year. The Battelsteins simply do not qualify.

We note further that even were this Court of the opinion that there are, as has been suggested, equitable considerations in this case favoring the Battelsteins, it has long been established that we may not allow such considerations to play a part in our decision. As panels of this Court have recently had occasion to reiterate, citing recent and established Supreme Court precedent, tax deductions are matters of legislative grace and must be narrowly construed. The taxpayer bears the burden of proving his entitlement to a particular deduction. Equity cannot supply a deduction when the Code does not grant one. See, e.g., *Lettie Pate Whitehead Foundation* v. *United States,* 606 F.2d 534; 539 (5th Cir. 1979); *C. A. White Trucking Co.* v. *Commissioner,* 601 F.2d 867, 869 (5th Cir. 1979).

The only question before us is whether the Battelsteins' check exchange scheme resulted in the payment of interest Section 163(a) requires. A review of the scheme under the familiar standards of appraisal mandated by the Supreme Court permits no conclusion other than that no interest was paid, and thus that no deduction may be allowed.

REVERSED AND REMANDED FOR A CALCULATION OF TAX LIABILITY.

POLITZ, Circuit Judge, with whom BROWN, RONEY, GEE, JAMES C. HILL, FAY, VANCE, GARZA, REAVLEY and RANDALL, Circuit Judges, join, dissenting:

Respectfully, I dissent. The Battelstein loan arrangement is precisely the type of transaction covered by the

Burgess rule.[1] In 1971 the Battelsteins borrowed in excess of three million dollars from the Gibraltar Savings Association to finance the Sharpstown project. They took additional loans from Gibraltar in 1973 and 1974. It is beyond dispute that a § 163(a) deduction is not available to the Battelsteins if notes alone, rather than cash or its equivalent, were given in payment of the accrued interest on the initial loan. But I cannot agree with the narrow characterization of this overall transaction as a paper shuffling sham composed of surrendered notes with check exchanges flying CAP. By declining to apply and raising the spectre of criticism of Burgess, the majority registers its objection to a 33 year old tax law precedent which is both logical and meritorious. I believe this rejection unjustified.

There is no question but that the § 163(a) interest deduction may be claimed in instances in which the interest is paid with the proceeds of a loan. If the Battelsteins had borrowed the money to pay the interest to Gibraltar from a different lender, no challenge would apparently be made to the interest deduction. It is only because the Battelsteins secured additional loans from Gibraltar, equal to the interest paid, that they forfeit the deduction. It is this dimension of the majority opinion with which we take issue, and for which the *Burgess* rule is particularly appropos. Its rejection causes the taxpayers of this circuit to run through a legal minefield they ought not have to cross. Today's decision portends the day when the § 163(a) deduction is put in jeopardy whenever a taxpayer borrows from a lender a sum at least equal to the interest paid that same lender that tax year.

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[1] *Burgess* v. *Commissioner*, 8 T.C. 47 (1947); as subsequently refined, *Burck* v. *Commissioner*, 63 T.C. 556 (1975), and *Wilkerson* v. *Commissioner*, 70 T.C. 240 (1978).

It is not difficult to envision completely unacceptable consequences of the rule of this case. Let us suppose that a homeowner/taxpayer has a $30,000 mortgage, required $300 monthly payments of principal and interest. Let us also suppose that he has an automatic $1,000 line of credit available if he should overdraw his personal account. The mortgage loan and the checking account, with the protective line of credit, are with the same bank. Let us further suppose that at various times during the year our hypothetical taxpayer either owes up to $1,000 or has several thousands of dollars, on demand deposit, depending on transitory seasonal fluctuations. Throughout the entire year his assets exceed $100,000 which, for his own reasons, he chooses not to liquidate during the "deficit" periods but opts to rely on borrowing in order to maintain financial flexibility. Under today's decision the deductibility of the mortgage interest is endangered because funds drawn on the line of credit may have been used to make the monthly mortgage payments. The risk is created simply because both loans came from the same lender. Proper application of the Burgess rule would assure this taxpayer safe passage.

The only credible distinction between the Battelsteins' predicament and that of our hypothetical taxpayer is that the former is structured and the latter is not. The Battelsteins appear to have designed their transaction to conform with existing case law and regulatory precedents. Our hypothetical taxpayer is in a quite common situation very probably affecting a substantial number of taxpayers. I am compelled to the conclusion that the Battelsteins are being penalized for trying to carefully fashion a tax oriented transaction designed to maximize tax advantages. Surely this effort is not proscribed. As was cogently observed by the eminent jurist Judge Learned Hand, "a transaction otherwise within an exception of the tax law, does not lose

its immunity, because it is actuated by a desire to avoid, or, if one chooses, to evade, taxation. Anyone may so arrange his affairs that his taxes shall be as low as possible; he is not bound to choose that pattern which will best pay the Treasury; there is not even a patriotic duty to increase one's taxes." *Helvering* v. *Gregory,* 69 F.2d 809, 810 (2d Cir. 1934), affirmed 293 U.S. 465, 55 S.Ct. 266, 79 L.Ed. 596 (1935).

The *Burgess* formulation, which I believe should govern disposition of this case, is a time tested amalgamation of various factors that aid courts in determining whether a taxpayer is perpetrating a dual loan transaction sham or is legitimately entitled to the interest deduction. To qualify for the tax deduction under the *Burgess* test it is necessary that: (1) there be valid and legitimate reasons for the second loan other than to repay interest on the first loan, (2) proceeds of the second loan are commingled with the taxpayer's other funds, (3) the taxpayer have funds or available resources to cover the interest payment, and (4) the lending institution loses control of the proceeds of the second loan. *Burgess; Burck* v. *Commissioner,* 63 T.C. 556 (1975), aff'd on other grounds, 553 F.2d 768 (2d Cir. 1976); *Wilkerson* v. *Commissioner,* 70 T.C. 240 (1978).

Factor one is satisfied because valid reasons existed for the subsequent loans, other than merely making interest payments on the first loan. Funds were required to finance development of the Sharpstown project which was a multi-million dollar long-range venture; roads were not in, utilities were not installed. The controversial subsequent loan agreement was really a clause contained in the Battelstein-Gibraltar loan accord that stated:

> After execution of the agreement Gibraltar will, pursuant to the terms thereof, from time to time, advance to Owners . . . an additional sum or sums of money equal

> to the Owners' actual out-of-pocket costs incurred and paid on said property subsequent to the execution of the agreement, including, but not being limited to debt services, taxes . . .

In return for this long term financing clause, Gibraltar was to be repaid the loans plus interest and receive a 19% interest in the net proceeds when the land was sold.[2] Jerry Battelstein was eager to obtain this type of financing because it did not tie up his own liquid assets; he testified that he firmly believed an astute businessman could make money with borrowed money. Advances were in fact made to the Battelsteins in 1973 and 1974 for sums equal to the ad valorem taxes paid on the land and for debt service or interest owed to Gibraltar on the initial loan.

It is clear that the subsequent loans were intended to place the full cost of acquisition and development of the Sharpstown property on Gibraltar in order to give the Battelsteins added financial flexibility. The majority's position focuses, in isolation, on the funds borrowed to pay interest charges on the first loan. No mention is made of the funds borrowed to pay the ad valorem taxes, the payment of which had been originally rejected as a deduction by the I.R.S. for the same reason, i.e., the funds used for payment had been borrowed from Gibraltar. This focusing obscures the business purpose of the subsequent loans, the underwriting of all "out of pocket" expenses associated with the Sharpstown parcel.

Factors (2) and (3) of *Burgess* are met. Proceeds of the second loan were commingled with personal Battelstein funds in their bank accounts (which were not with Gibraltar). Additionally, in each of the eight challenged instances of payment (quarterly during the two-year period under

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[2] Interest rates and due dates on the subsequent loans differed from those on the first loan.

scrutiny) the Battelsteins had ample assets to cover taxes and interest payments independent of the subsequent loan proceeds. During the years 1973, 1974 and 1975, Jerry Battelstein's average monthly checking account balances were $24,000, $75,000 and $35,000 respectively. Barry Battelstein's monthly averages during those years were $36,000, $44,000 and $40,000. Jerry Battelstein's approximate net worth exceeded four million dollars in 1973 and was over five million in 1974. Similarly, Barry Battelstein had substantial assets upon which to draw for payments. For example, in 1973 he had $1,300,000 worth of Certificates of Deposit that could have been liquidated to pay accruing ad valorem taxes and interest charges on the first loan. During the years in question accruing interest paid with funds borrowed under the second loan accord fluctuated between $4,991.06 and $48,728.10. It cannot be disputed that the Battelsteins had more than adequate funds to pay the quarterly interest, independent of any monies received on later advances from Gibraltar.

Finally, *Burgess* requires that Gibraltar relinquish total control of the questioned loan proceeds. From the majority's perspective, the sequencing of checks between the Battelsteins and Gibraltar conclusively proved that the bank's control of these funds was not extinguished because an "inconsequential exchange of surrendered notes" occurred rather than a cash payment of interest. Emphasis is placed on the fact that the Battelsteins first sent their checks for the quarterly interest payments at which time Gibraltar sent the Battelsteins a like check which they deposited in their general bank accounts. I find this significant, but reach a conclusion exactly opposite from that of the majority. Upon receipt of the Battelsteins' check, Gibraltar had made more than a mere promise to pay (such as would be evidenced by a note). When Gibraltar received the checks the Battelsteins had paid. Had Gibraltar chosen for some reason not

to loan an amount equal to the particular payment, the Battelsteins would have been obliged to see that the check was honored out of their own substantial personal funds. Sending those checks was the equivalent of sending cash. The record reflects that in some instances the funds on deposit when Gibraltar received the checks were sufficient to cover the checks before Gibraltar made any further loan; and in every instance, the Battelsteins had more than adequate resources available. The record also reflects that in some instances the check to Gibraltar was debited before the proceeds from the Gibraltar check were deposited.

It is apparent that in many, if not most "dual loan" cases the *Burgess* requirements would preclude the taxpayer from taking the interest deduction. That is all the more reason to support the application of *Burgess* in a proper case. I view this as just such a case. The Tax Court continues to support the rule in appropriate cases.[3] *Heyman* v. *Commissioner,* 70 T.C. 482 (1978); *Alan A. Rubnitz,* 67 T.C. 621 (1977); *Nat Harrison Associates, Inc.,* 42 T.C. 601 (1964).

The majority opinion occasions further comments which perhaps might best be stated in the form of inquiries. Set-

[3] In *Goodstein* v. *C.I.R.,* 267 F.2d 127 (1st Cir. 1959), the First Circuit affirmed a Tax Court holding which characterized a transaction within the Cleaver mold, thereby denying the taxpayer the interest deduction. The court, somewhat cryptically said, "Taxpayer cites *Newton A. Burgess* . . . which would seem to hold to the contrary but to us the reasoning of the dissenting members of the court is more persuasive." *Goodstein* at 131. This waffling rejection of *Burgess* should be scrutinized in light of the facts before the court. Both the Tax Court and the Court of Appeals determined the *Goodstein* transaction was devoid of economic substance beyond the purpose of obtaining an interest deduction. Indeed, the plan in that case was devised by an accountant who contacted the IRS to test whether the preconceived plan would result in a tax deduction. *Goodstein* is, therefore, distinguishable from the present case; it ignores the first noted test in the *Burgess* exception, perhaps because the transaction in that case was undeserving of the exception. In writing the *Burck* affirmance for the Second Circuit, Judge Oakes expressed these reservations "for himself only," the *Burgess* rule was not the subject of review.

ting aside for the moment the permutation of cash versus accrual basis and date of crediting in determining taxable income we inquire, in general terms, about the tax posture of Gibraltar. What may we safely assume to be the position of the I.R.S. as respects the Battelsteins' interest payments? Was that reportable income to Gibraltar? When did it become so? May Gibraltar insist that it did not receive the interest payments due on the initial loan because it made other loans at different rates of interest and with different due dates?

Viewing the total transaction from the standpoint of the Battelsteins we must also inquire. The development envisioned the sale of the property, presumably at a handsome profit. One would assume that was the early expectation. What would have been the position of the I.R.S. had the Battelsteins borrowed from Gibraltar (and other institutions) all sums necessary to make the quarterly interest payments over a several year period, and timed or extended the subsequent loans so that all came due in the year of the sale, to be used in a lump sum against the profit realized? One need hardly doubt the reception that program would have gotten.

The essential predicate for the majority opinion is that the subsequent loans came from the same lender. How far do we extend the "sameness"? What about a loan from a subsidiary or affiliated lending institution or from a sibling bank which happens to be a member of the growing banshare-type organization? Will we not be compelled to articulate a *Burgess* type rubric?

I am convinced beyond peradventure that the Burgess test is applicable to this case and should be endorsed. I would affirm the decisions of the bankruptcy court and the district court allowing the interest deduction. I therefore respectfully DISSENT.

BARRY L. BATTELSTEIN
and JERRY E. BATTELSTEIN,
Plaintiffs-Appellees,

v.

INTERNAL REVENUE SERVICE,
Defendant-Appellant.

No. 77-3212

UNITED STATES COURT OF APPEALS,
FIFTH CIRCUIT.

February 14, 1980.

Rehearing En Banc Granted
April 11, 1980.

Cash basis taxpayers filed Chapter XI bankruptcy petition. The bankruptcy judge denied claims filed by Internal Revenue Service. The United States District Court for the Southern District of Texas, John V. Singleton, Jr., Chief Judge, affirmed, and IRS appealed. The Court of Appeals, Frank M. Johnson, Jr., Circuit Judge, held that where lender agreed to make to borrowers, cash basis taxpayers, future advances of interest as it becomes due and each quarter lender would notify borrowers of current interest due, whereon borrowers would send lender a check in such amount and, on receipt, lender would send borrower its check in the identical amount, such exchange of checks did not result in interest being "paid" so as to be deductible in computing federal income tax, notwithstanding that the indebtedness and interest opportunities apparently had business substance.

Reversed and remanded with directions.
Politz, Circuit Judge, dissented.

1. Internal Revenue — 518

Notes which cash basis taxpayer may have given lender for interest advances could have not have resulted in payment thereof for federal income tax purposes, as "payment" for tax purposes must be made in cash or its equivalent, and a note promising payment of cash in the future is not "cash" or its equivalent. 26 U.S.C.A. (I.R.C.1954) §163(a).

See publication Words and Phrases for other judicial constructions and definitions.

2. Internal Revenue — 518

Where lender agreed to make to borrowers, cash basis taxpayer, future advances of interest as it became due and each quarter lender would notify borrowers of current interest due, whereon borrowers would send lender a check in such amount and, on receipt, lender would send borrower its check in the identical amount, such exchange of checks did not result in interest being "paid" so as to be deductible in computing federal income tax, notwithstanding that the indebtedness and interest opportunities apparently had business substance. 26 U.S.C.A. (I.R.C.1954) §163(a).

See publication Words and Phrases for other judicial constructions and definitions.

3. Internal Revenue — 518

Where taxpayer borrows money from a third party to pay interest due his original lender, the interest is considered paid and deductible in computing federal income tax; in the third-party situation, deduction is appropriate because the obligation as between the borrower and original lender has not been postponed, it has been extinguished, and a default by taxpayer would not revive it. 26 U.S.C.A. (I.R.C.1954) §163(a).

M. Carr Ferguson, Asst. Atty. Gen., Gilbert E. Andrews, Acting Chief, App. Section, Robert A. Bernstein, Gayle P. Miller, William Friedlander, Attys., Tax Div., Dept. of Justice, Washington, D.C., for defendant-appellant.

Marc E. Grossberg, David Cowan, Hugh M. Ray, Houston, Tex., for plaintiffs-appellees.

Appeal from the United States District Court for the Southern District of Texas.

Before COLEMAN, Chief Judge, FRANK M. JOHNSON, Jr. and POLITZ, Circuit Judges.

FRANK M. JOHNSON, Jr., Circuit Judge:

Barry L. Battelstein in November, 1976, and Jerry E. Battelstein in April, 1977, filed Chapter XI petitions in bankruptcy in the United States District Court for the Southern District of Texas. In the ensuing proceedings, the Internal Revenue Service (IRS) filed proof of claims against each. The Battelsteins objected to the claims and their objections were consolidated for trial. In June, 1977, after trial, the bankruptcy judge denied the IRS claims. In August, 1977, the district court affirmed this denial. The IRS filed this appeal.

The controversy stems from deductions claimed by the Battelsteins for interest paid on indebtedness. The Battelsteins were land developers. Gibraltar Savings Association was their lender. In 1971, Gibraltar agreed to loan the Battelsteins more than three million dollars to cover the purchase of a piece of property known as Sharpstown. Gibraltar also agreed to make to the Battelsteins, if desired, future advances of the interest costs on this loan as they became due.[1] As it happened, the Battelsteins never paid

[1] In partial consideration of its entrance into the agreement Gibraltar was promised a 19 per cent profit participation in the value of the property when finally sold.

interest except by way of these advances. Each quarter, Gibraltar would notify the Battelsteins of current interest due. The Battelsteins would then send Gibraltar a check in this amount, and, on its receipt, Gibraltar would send the Battelsteins its check in the identical amount. Although the 1971 agreement provided that these advances were to be evidenced by new notes, it is unclear whether new notes were ever executed.[2] The bankruptcy judge and the district judge found that the Battelsteins were correct in deducting the amount of the interest as interest paid on indebtedness. This finding was clearly in error.

Under §163(a) of the Internal Revenue Code of 1954, 26 U.S.C. §163(a), cash basis taxpayers such as the Battelsteins may take a deduction for interest paid within the taxable year on indebtedness. The dispute in this case turns on whether or not the Gibraltar-Battelstein arrangement resulted in interest being "paid."

[1] The Battelsteins do not contend, nor could they seriously, that any of the notes they they may have given Gibraltar for the interest advances could have resulted in payment. As the Supreme Court recently reiterated in a related context, payment for tax purposes must be made in cash or its equivalent, and a note promising payment of cash in the future is not cash or its equivalent. *Don E. Williams Co.* v. *Commissioner,* 429 U.S. 569, 577-78, 97 S.Ct. 850, 51 L.Ed.2d 48 (1977).[3] The Court explained that the note may never be paid, and if it is not paid, the

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[2] The Battelsteins testified that they could not recall.

[3] In the *Williams* case, the Court relied on two earlier decisions articulating the same principle; *Helvering* v. *Price,* 309 U.S. 409, 60 S.Ct. 673, 84 L.Ed. 836 (1940), and *Eckert* v. *Burnet,* 283 U.S. 140, 51 S.Ct. 373, 75 L.Ed. 911 (1931). Based on *Price, Eckert,* or other precedent established on their authority, courts have

taxpayer has parted with nothing more than his promise. Id. at 578, 97 S.Ct. 850, quoting *Hart* v. *Commissioner,* 54 F.2d 848, 852 (1st Cir. 1932).

[2] The Battelsteins strenuously argued that the exchange of checks with Gibraltar did result in interest being "paid". This argument is without merit. The Battelsteins have asserted business reasons for putting off the interest payments,[4] but they do not assert, nor is it possible to infer, any purpose other than tax avoidance for the check exchange method employed to do so. Although there are a great many transactions which may properly be undertaken principally with a view of minimizing taxes, e.g., buying tax-free municipal bonds instead of higher yielding corporate securities, or selling property at the close of one year rather than the start of another in order to accelerate the recognition of a loss, creating a superficial payment struc-

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refused to consider "paid" and deductible interest satisfied by a note promising future payment, *Hart* v. *Commissioner,* 54 F.2d 848, 850-52 (1st Cir. 1932); interest "withheld" by the lender from the original loan, *Parks* v. *United States,* 434 F.Supp. 206, 211 (N.D.Tex.1977); *Heyman* v. *Commissioner,* 70 T.C. 482, 485-87 (1978); *Rubnitz* v. *Commissioner,* 67 T.C. 621, 628 (1977); *Hopkins* v. *Commissioner,* 15 T.C. 160, 181 (1950); *Cleaver* v. *Commissioner,* 6 T.C. 452, 454 (1946), at 158 F.2d 342, 344 (7th Cir.) cert. denied, 330 U.S. 849, 67 S.Ct. 1093, 91 L.Ed. 1293 (1947); interest "withheld" by the lender from a subsequent loan, *Keith* v. *Commissioner,* 139 F.2d 596, 597 (2d Cir. 1944); *Nat Harrison Associates, Inc.* v. *Commissioner,* 42 T.C. 601, 623-25 (1964); or interest paid by an increase in the original principal, *England* v. *Commissioner,* 34 T.C. 617, 621 (1960). In *Williams,* the Court noted the *Cleaver* decision, 429 U.S. at 578 n.9, 97 S.Ct. 850, and quoted from *Hart, Id.* at 578.

[4] The bankruptcy judge found that the loan agreement was "clearly no sham business deal conceived solely to render the debtors a tax deduction," and explained that the business purpose of the interest advances was "to enable the owners of the Sharpstown property to maintain ownership of the property for an extended period of time, and to make improvements, including the addition of utilities."

ture solely to reap the benefits of §163(a) is not one of them. See *Knetsch* v. *United States*, 364 U.S. 361, 367 81 S.Ct. 132, 5 L.Ed.2d 128 (1960); *Salley* v. *Commissioner*, 464 F.2d 479, 480, 482-83 (5th Cir. 1972); *Goldstein* v. *Commissioner*, 364 F.2d 734, 740 (2d Cir. 1966).[5] To give significance to the check exchange would be to exalt artifice over reality and deprive §163(a) of all serious purpose. *Cf. Gregory* v. *Helvering*, 293 U.S. 465, 470, 55 S.Ct. 266, 79 L.Ed. 596 (1935). Given its sham nature, the exchange should be ignored. See *Waterman Steamship Corp.* v. *Commissioner*, 430 F.2d 1185, 1192 (5th Cir. 1970); *Owens* v. *Commissioner*, 568 F.2d 1233, 1240 (6th Cir. 1977); *Gilbert* v. *Commissioner*, 248 F.2d 399, 411 (2d Cir. 1957) (Hand, J., dissenting). When the exchange is ignored, it is obvious that the Battelsteins' arrangement resulting in nothing more than promises to pay and not, as the Supreme Court has required, actual payment. See *Don E. Williams Co.* v. *Commissioner*, supra, 429 U.S. at 578, 97 S.Ct. 850. Accordingly, the deductions should not have been allowed.

The Battelsteins' reliance on the line of Tax Court cases beginning with *Burgess* v. *Commissioner*, 8 T.C. 47 (1947), is misplaced.[6] The *Burgess* cases establish an exception inapplicable to the facts of this case. In *Burgess* and its progeny, the Tax Court held that interest may be con-

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[5] Section 163(a) is an accounting provision and, like tax accounting provisions generally, it invites evasion. In the cases cited, taxpayers structured elaborate loan transactions in order to create indebtedness giving rise to interest deduction opportunities. Finding that the transactions had no purpose other than tax avoidance, the courts disallowed the interest deductions in full. In this case, the indebtedness and interest opportunities apparently had business substance; it was the check exchange method claimed to have "paid" them that did not. The distinction is unimportant.

[6] *Burgess* was followed in *Burck* v. *Commissioner*, 63 T.C. 556 (1975), aff'd on other grounds, 533 F.2d (2d Cir. 1976), and again in *Wilkerson* v. *Commissioner*, 70 T.C. 240 (1978).

sidered paid even though the taxpayer may have paid it with money subsequently borrowed from the initial lender, so long as the money subsequently borrowed actually passed into the hands or bank account of the taxpayer, was commingled with the other funds of the taxpayer and thus became subject to the taxpayer's unrestricted control. *Burgess* v. *Commissioner,* supra, 8 T.C. at 49-50. See also *Wilkerson* v. *Commissioner,* 70 T.C. 240, 257-61 (1978); *Burck* v. *Commissioner,* 63 T.C. 556, 559-60 (1975), aff'd on other grounds, 533 F.2d 768 (2d Cir. 1976). Here the last condition was not satisfied. Because Gibraltar did not issue the Battelsteins its check until it had their check already in hand, it cannot be said that the interest money advanced by Gibraltar ever became commingled with the Battelsteins' other funds and subject to the Battelsteins' unrestricted control. Moreover, it should be kept in mind that the *Burgess* conditions were apparently developed as a guide to distinguish sham payments from legitimate payments. The conditions notwithstanding, the Battelsteins' check exchange was, as noted above, obviously a sham.

[3] Even if applicable, the *Burgess* exception is of doubtful validity.[7] The principal distinction between the *Burgess* case and the *Don E. Williams Co.* cases[8] is that in the *Burgess* cases the payment of interest claimed by the taxpayer was alleged to have occurred not through a paper transaction with the lender of the principal, such as the giving of a note or the withholding of interest from principal, but by an actual exchange of funds. See *Burgess* v. *Commissioner,* supra, 8 T.C. at 49-50. This dis-

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[7] The exception has been much criticized. See *Burck* v. *Commissioner,* 533 F.2d 768, 770 n.3 (2d Cir. 1976); *Goodstein* v. *Commissioner,* 267 F.2d 127, 131 (1st Cir. 1959); *Burgess* v. *Commissioner,* supra, 8 T.C. at 50-51 (Kern, J., dissenting for himself and five other Tax Court judges).

[8] See note 3 supra.

tinction has no creditable basis. *Id.* at 50-51 (Kern, J. dissenting). The lender's additional loan and the taxpayer's 'payment' of interest add up to no more than a postponement, not payment, of the taxpayer's interest obligation to the lender. *Cf. Minnesota Tea Co.* v. *Helvering,* 302 U.S. 609, 613, 58 S.Ct. 393, 395, 82 L.Ed. 474 (1938) ("A given result at the end of a straight path is not made a different result because reached by following a devious path.") Contrary to the Battelsteins' claims, the distinction is not saved by analogy to the well-established rule that, where a taxpayer borrows money from a third party to pay interest due his original lender, the interest is considered paid and deductible. See, e.g., *McAdams* v. *Commissioner,* 15 T.C. 231, 235 (1950). This rule is clearly inapposite. In the third-party situation, deduction is appropriate because the obligation as between the borrower and the original lender has not been postponed, it has been extinguished. A default by the taxpayer would not revive it. *Crain* v. *Commissioner,* 75 F.2d 962, 964 (8th Cir. 1935). This is not the case where the taxpayer 'satisfies' his interest obligation with additional borrowings from his original lender. The obligation as between the borrower and the lender remains but, like a note promising payment in the future, merely in another form. *Burgess* provides an opportunity for tax advoidance that § 163(a) clearly did not intend. Were we to find, as did the district court, that *Burgess* is here applicable, we would decline to follow it and disallow the Battelsteins' deductions.

REVERSED AND REMANDED FOR A CALCULATION OF TAX LIABILITY

POLITZ, Circuit Judge, dissenting:

I respectfully dissent. The rejection of the *Burgess*[1] "exception" is not justified. The majority opinion ascribed undue emphasis to the source of the funds used to make the interest payments, finding same came from the lender of the principal loan. A single factor should not dominate, but rather the totality of the circumstances should control deductibility of interest payments under 26 U.S.C. § 163(a). This decision hangs an ominous question mark over interest deductions in every instance in which a borrower secures, from the same lender, a subsequent loan equal to or greater than the interest paid in that tax year. I recognize that there must be very careful safeguards in this area or there will be abuses. But we need not hurt hummingbirds with shotguns.

I fully endorse the rules of law collated and enunciated by the majority to the effect that for an interest deduction to be allowed the payment must be in cash or its equivalent, a note alone, evidencing a future obligation is not enough, a sham exchange is to be ignored and a superficial payment structure created solely to reap undue benefits under § 163(a) is not to be given force and effect. However, the factual situation before us, as found by the Bankruptcy Judge and affirmed by the District Court is not inconsistent with these general rules and upon the facts so found (which are essentially not disputed) the interest deductions were appropriate and should be allowed.

My concern is heightened by the realization that if the taxpayers had borrowed the funds needed for the inter-

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[1] *Burgess* v. *Commissioner*, 8 T.C. 47 (1947).

est payments from another lender the deduction would probably not have been challenged, and if challenged, would apparently have been approved by the majority.

For over 30 years the *Burgess explication* of a particular application of § 163(a) has been a part of the jurisprudence. As the majority notes, it has been both followed and criticized. I believe it more worthy of support than criticism. The rule of *Burgess* and its progency is of value and ought to be available to taxpayers in this circuit.

The material facts found by the Bankruptcy Court are not contested. Barry Battelstein and Jerry Battelstein entered into a loan agreement with Gibraltar Savings Association in January 1971 in order to finance the purchase and development of a piece of property. The Battelsteins and other owners intended to develop the property which, at the time of purchase, did not have utilities. The Association agreed to make future loans to the owners to carry the cost of the property. In return the Association was to receive, in addition to repayment of its loans, a 19% interest in the net proceeds of sale of the property.

The loan agreement contained this salient language:

> After execution of the agreement Gibraltar will, pursuant to the terms thereof, from time to time, advance to Owners . . . an additional sum or sums of money equal to the Owners' actual out-of-pocket costs incurred and paid on said property subsequent to the execution of the agreement, including, but not being limited to debt services, taxes . . .

The Association, pursuant to this provision, made subsequent advances (loans) to the owners, at higher interest rates than the original acquisition loan, with different maturity dates and secured by additional liens on the

property. During 1973 and 1974 additional loa[illegible] were made to the Battelsteins for sums equal to ad [illegible]orem taxes they paid and for debt service or interest charges they owed the Association and timely paid. The IRS challenged the deductibility of the interest payments and the ad valorem tax payments on the same grounds, that the source of the funds was the Association and thus no deduction could be taken because no payment had been made. The bankruptcy and district courts rejected the challenges to deduction of both the interest payment and the ad valorem tax payments. No appeal was taken to the rejection of the challenge to the deduction for ad valorem taxes. That issue leaves the case, presumptively because the IRS concluded that challenge was not well founded.

Jerry Battelstein claimed the interest deduction for both tax years at issue, 1973 and 1974. Barry Battelstein claimed the interest deduction for 1973 but capitalized the expense in 1974 under § 266 of the Internal Revenue Code.

These further facts were found. The Battelsteins were not obliged to borrow the additional sums from Gibraltar. Further, in each of the eight challenged instances of payment (quarterly during the two year period) they had sufficient funds in their general bank accounts (maintained with another institution, not Gibraltar) to cover the payments for interest and taxes or very ample resources from which the taxes and interest could have been paid. During the years 1973, 1974 and 1975 Jerry Battelstein's average monthly checking account balances were $24,000, $75,000 and $35,000, respectively. Barry Battelstein's monthly averages during those years were $36,000, $44,000 and $40,000. Jerry Battelstein's approximate net worth exceeded four million in 1973 and was over five million in 1974. Barry

Battelstein had substantial assets upon which to draw for payments, for example in 1973 he had $1,300,000 in Certificates of Deposit readily available. The interest payments during the period fluctuated between $4,991.06 and $48,728.10. It cannot be gainsaid that the Battelstein's had adequate funds to pay the interest independent of the funds received from Gibraltar.

Another cogent consideration is whether the subsequent loans had any economic utility other than to serve as the basis of a claimed tax deduction. The trier of fact found that such utility existed. I fully agree. The loan agreement was intended to keep the Battelsteins and the other owners in a position where Gibraltar carried the full cost of acquisition and development of the property. The money was available. Jerry Battelstein testified that he subscribed to the theory that money could be made with borrowed money. This gave the Battelsteins added financial flexibility. And this must be viewed in light of the fact that Gibraltar would receive a 19% interest in the net proceeds of sale. These subsequent loans had an obvious economic utility.

The majority opinion assigns substantial import to the sequencing of checks between the Battelsteins and Gibraltar. It is said that in each instance the Battelsteins sent their respective checks for the quarterly interest payments at which point Gibraltar sent the Battelsteins a like check which the Battelsteins deposited in their general bank accounts. I find this significant, but reach a conclusion exactly opposite from that of the majority. When Gibraltar received the Battelsteins' checks there is more than simply the Battelsteins' promise to pay (such as would be evidenced by a note). They had indeed paid. The facts show that in some instances sufficient funds were on deposit in the Battelsteins' accounts to fully cover these checks and in every instance more than adequate resources existed for

payment. Gibraltar sent its checks and they were deposited in the general bank accounts of the Battelsteins in another institution and commingled and utilized for whatever purpose. It cannot be claimed that the subsequent loans proceeds were used exclusively for payment of the quarterly interest payments for the facts do not support that conclusion.

The *Burgess* requirements, as subsequently refined, establish adequate safeguards to avoid the very real possibilities of abuse in dual loan transaction situations. In essence it is necessary that: (1) there be valid and legitimate reasons for the second loan other than to repay interest on the first loan, (2) proceeds of the second loan are commingled with the taxpayer's other funds, (3) the taxpayer have funds or available resources to cover the interest payment, and (4) the lending institution loses control of the proceeds of the second loan. *Burgess; Burck* v. *Commissioner,* 63 T.C. 556 (1975) aff'd on other grounds, 533 F.2d 768 (2nd Cir. 1976); *Wilkerson* v. *Commissioner,* 70 T.C. 240 (1978).

The factual grounding of many "dual loan" cases precludes the taxpayer from taking the deduction under *Burgess,* however the Tax Court has consistently recognized the rule's applicability in proper cases. *Heyman* v. *Commissioner,* 70 T.C. 482 (1978); *Alan A. Rubnitz,* 67 T.C. 621 (1977); *Nat Harrison Associates, Inc.* 42 T.C. 601 (1964).[2]

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[2] In *Goodstein* v. *C.I.R.,* 267 F.2d 127 (1st Cir. 1959), the First Circuit affirmed a Tax Court holding which characterized a transaction within the *Cleaver* mold, thereby denying the taxpayer the interest deduction. The court, somewhat cryptically said, "Taxpayer cites *Newton A. Burgess,* . . . which would seem to hold to the contrary but to use the reasoning of the dissenting members of the court is more persuasive". *Goodstein* at 131. This waffling rejection of Burgess should be scrutinized in light of the facts before the court. Both the Tax Court and the Court of Appeals determined the *Goodstein* transaction was devoid of economic substance beyond the purpose of obtaining an interest deduction.

I am convinced that all four of the above noted requirements are met in this case. I believe the *Burgess* test to be fair and workable. I would apply it. I see a vast difference between a carefully fashioned financial program, one intentionally designed to maximize valid tax advantages, and an artfully devised scheme to evade taxes. The latter is to be abrogated. To reject an instance of the former is a policy judgment only the Congress should make in the quest for tax reform.

For these reasons I would affirm the decisions of the bankruptcy and district courts allowing the interest deductions and I, therefore, respectfully dissent.

Indeed, the plan in that case was devised by an accountant who contacted the IRS to test whether the pre-conceived plan would result in a tax deduction. *Goodstein* is, therefore, distinguishable from the present case; it ignores the first noted test in the *Burgess* exception, perhaps because the transaction in that case was undeserving of the exception. In writing the *Burck* affirmation for the Second Circuit, Judge Oakes states in fn. 3 that he disagreed with the *Burgess* majority. Judge Oakes expressed these reservations "for himself only", the *Burgess* rule was not the subject of review.

IN THE UNITED STATES DISTRICT COURT
FOR THE SOUTHERN DISTRICT OF TEXAS
HOUSTON DIVISION

BARRY L. BATTELSTEIN
JERRY E. BATTELSTEIN
Plaintiffs,
v.
INTERNAL REVENUE SERVICE

CIVIL ACTION No. H-77-1254

ORDER

The above-styled-and-numbered cause is an appeal taken by the Director of Internal Revenue pursuant to Bankruptcy Rule 801. The Director appeals from the denial of its claims in two Chapter XI Arrangements which were consolidated for purposes of adjudication of such claims. In two orders entered on June 27, 1977, the bankruptcy court denied or reduced the Director's claims for internal revenue taxes in *In re Jerry E. Battelstein,* Bankruptcy No. 77-H-240, and *In re Barry L. Battelstein,* Bankruptcy No. 76-H-785.

Upon careful consideration of the record on appeal and pursuant to Bankruptcy Rule 810, this court finds that the bankruptcy court's findings and orders are neither clearly erroneous nor contrary to law. Therefore, it is ORDERED, ADJUDGED, and DECREED that the orders of the bankruptcy court be, and the same hereby are, AFFIRMED.

DONE at Houston, Texas, on the 29th day of August, 1977.

.....
United States District Judge

IN THE UNITED STATES DISTRICT COURT
FOR THE SOUTHERN DISTRICT OF TEXAS
HOUSTON DIVISION

BARRY L. BATTELSTEIN
JERRY E. BATTELSTEIN
v.
INTERNAL REVENUE SERVICE

CIVIL ACTION No. H-77-1254

FINAL JUDGMENT

The Court, Hon. John V. Singleton, Jr., United States District Judge, by Order on this Date, having AFFIRMED the orders of the bankruptcy court,

Judgment is hereby entered in favor of the Plaintiffs and against the Defendant.

DATED at Houston, Texas, this 5th day of December, 1977.

ENTERED NUNC PRO TUNC, effective the 29th day of August, 1977.

V. BAILEY THOMAS, Clerk

By .....
Deputy Clerk

IN THE UNITED STATES DISTRICT COURT
FOR THE SOUTHERN DISTRICT OF TEXAS
HOUSTON DIVISION

In RE: BARRY L. BATTELSTEIN *Debtor*	IN CHAPTER XI ARRANGEMENT BANKRUPTCY No. 76-H-785

ORDER REDUCING CLAIM

The Objection of Barry L. Battelstein, the above named Debtor to the allowance of the claim of the Directory of the Internal Revenue Service, filed by the United States of America herein being Claim No. 28, having been heard by the Court and the Court having rendered its Memorandum Opinion containing Findings of Fact and Conclusions of Law, it is

ORDERED that the Claim of the Internal Revenue Service, be and same is hereby reduced to $25,074, and allowed at said amount.

SIGNED and ENTERED the 27th day of June, 1977.

.....
Bankruptcy Judge

IN THE UNITED STATES DISTRICT COURT
FOR THE SOUTHERN DISTRICT OF TEXAS
HOUSTON DIVISION

In RE: JERRY E. BATTELSTEIN *Debtor*	}	IN CHAPTER XI ARRANGEMENT BANKRUPTCY No. 77-H-240

ORDER DENYING CLAIM

The Objection of Jerry E. Battelstein, the above named Debtor to the allowance of the claim of the Director of the Internal Revenue Service, filed by the United States of America herein being Claim No. 15, having been heard by the Court and the Court having rendered its Memorandum Opinion containing Findings of Fact and Conclusions of Law, it is

ORDERED that the Claim of the Internal Revenue Service, be and same is hereby disallowed in its entirety.

SIGNED and ENTERED this 27th day of June, 1977.

.....
Bankruptcy Judge

IN THE UNITED STATES DISTRICT COURT
FOR THE SOUTHERN DISTRICT OF TEXAS
HOUSTON DIVISION

IN THE MATTER OF BARRY L. BATTELSTEIN JERRY E. BATTELSTEIN *Debtors* BARRY L. BATTELSTEIN JERRY E. BATTELSTEIN *Plaintiffs* v. DIRECTOR OF INTERNAL REVENUE SERVICE *Defendant*	IN BANKRUPTCY No. 76-HS-785 HS-77-240 ADVERSARY E ADVERSARY B [Filed June 13, 1977]

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MEMORANDUM OPINION ON OBJECTION TO CLAIM

WILLIAM M. SCHULTZ
UNITED STATES BANKRUPTCY JUDGE

Barry L. Battelstein filed a Chapter XI petition on November 1, 1976, and Jerry E. Battelstein filed a Chapter XI petition on April 1, 1977. The Internal Revenue Service filed proofs of claim against each debtor, based upon assessments made for 1973 and 1974 federal income taxes. The claim against Barry Battelstein is in the amount of $62,484 and against Jerry Battelstein in the amount of $50,223.11.

The debtors objected to the claims on the ground that they were entitled to certain of the deductions on which the assessments were predicated. The assessments emanate from the Internal Revenue Service disallowance, which the debtors challenge, of interest and ad valorem tax deductions in the years 1973 and 1974 by Jerry Battelstein and similar deductions, in the year 1973, by Barry Battelstein. The two contested matters were consolidated for trial purposes only and a hearing on objection to the claims was held. Each debtor also amended his objection to the claims to include a request that the Government pay the cost of reasonable attorney's fees incurred in objecting to the claims. The parties submitted post-trial briefs.

Based upon the uncontroverted testimony adduced before the Court, I make the following findings of fact:

The debtors and others entered into an initial loan agreement with Gibraltar Savings Association on January 27, 1971, to finance the purchase and development of a piece of property known as the "Sharpstown Property." Due to a desire on the part of the Battelsteins and other owners to develop the property, which at the time of purchase did not have utilities, the Association agreed to make future loans to the owners to carry the cost of the property until its ultimate use was achieved.

The salient language of the agreement provided:

> "After execution of the agreement Gibraltar will, pursuant to the terms thereof, from time to time, advance to Owners . . . an additional sum or sums of money equal to the Owners' actual out-of-pocket costs incurred and paid on said property subsequent to the execution of the agreement, including, but not being limited to debt services, taxes . . ."

Subsequent advances, hereinafter called loans, were made to the debtors by the Association which were secured by additional liens on the property. As partial consideration for the Association loaning funds to the owners to defray the carrying costs, Gibraltar received first, repayment of all loans made and interest on those loans, plus 19% of all remaining proceeds after deducting the expenses of any sale of the property.

The debtors, pursuant to the loan agreement, in 1973 and 1974 borrowed funds from Gibraltar to pay current interest and current taxes on the property. These subsequent loans were made by Gibraltar at a higher rate of interest than the initial note and with different maturity dates.

The debtors testified that they were not required to borrow the funds from Gibraltar. Moreover, two out of eight times they had adequate funds in their general bank accounts to make the payments and the other six times they had substantial resources from which the interest and taxes could have been paid. Furthermore, the debtors stated that they could have borrowed the funds from another source. Jerry Battelstein's average monthly checking account bank balances were $24,000; $75,000; and $35,000 during 1973, 1974 and 1975; Barry Battelstein's average monthly balances were $36,000; $44,000; and $40,000 during the same period.

The loan proceeds were deposited in the debtors' regular checking accounts and the funds commingled with the debtors' other funds. Gibraltar had no control over the funds advanced to the debtors and there was no agreement restricting the use of the funds. The debtors paid the interest and tax expenses by their checks.

The two issues involved in this action are whether the debtors, as cash basis taxpayers, have paid the interest in in terms of § 163(a) of the Internal Revenue Code and thus would be entitled to deduct interest paid on the loan to purchase the "Sharpstown Property"; and, whether the payments for ad valorem taxes on that same property were deductible under § 164(a)(1) of the Internal Revenue Code.

The basis for the allowance of an interest deduction is found in the Internal Revenue Code § 163(a), 26 U.S.C. § 163(a), which provides:

> "There shall be allowed as a deduction all interest paid or accrued within the taxable year on indebtedness."

However, a taxpayer on cash basis may deduct interest only when actually paid. *United States* v. *Collier,* 104 F.2d 420 (5th Cir. 1939); 2 *Merten's Law of Federal Income Taxation,* § 12.58, p. 220.

Furthermore, "no deduction will be allowed unless interest is paid in a transaction where some economic benefit other than reducing taxes is calculated to inure to the taxpayer." *2 Mertens Law of Federal Income Taxation,* §12.58 p. 221. This restriction on allowance of the deduction is illustrated in the case of *Goldstein* v. *Commissioner,* 364 F.2d 734 (2d Cir. 1966).

> "The interest deduction should be permitted whenever it can be said that the taxpayer's desire to secure an interest deduction is only one of the mixed motives that prompts the taxpayer to borrow funds; or... the deduction is proper if there is some substance to the loan arrangement beyond the taxpayer's desire to secure the deduction." *Id.* at 741.

Consequently, there must always be a court finding of "economic utility" with regard to the transaction for the court to allow the interest deduction.

Only two Tax Court cases have dealt with fact situations similar to this case, and in both such cases the courts deviated from the general rule and held for the taxpayers. The cases are *Burgess* v. *Comm'r.*, 8 T.C. 47 (1947) and *Burck* v. *Comm'r.* 63 T.C. 556 (1975). The general rule abrogated by both cases is that "when a taxpayer, on cash basis, borrows from a creditor there has been no cash payment of interest which is deductible from gross income." *Burgess* v. *Comm'r.*, 8 T.C. at 151 (rule as stated by the dissent).

The *Burgess* and *Burck* courts based their deviation from the general rule on the facts of the cases. In the cases the loans were obtained to pay several bills, including interest, and the loan funds were commingled with the funds in the taxpayers' regular bank accounts so as to lose their identity. One distinction exists between the two cases. In *Burgess* the court acknowledged that without the loan funds there would have been insufficient money in the debtor's account to pay the interest and the other bills; whereas in the *Burck* case the court took the opportunity to point out that the loan to the taxpayer was not material because even without the loan proceeds the debtor could have paid the interest and his other bills. Thus, it is unclear what weight the Tax Court gives to the inability of the debtor to pay his interest due without additional loan proceeds.

Under existing case law it appears that employing the proper technique in arranging transactions which result in the interest deduction is important.

For example, it is well settled that a cash basis taxpayer will be denied a deduction where he received the face amount of the new loan, less the interest retained by the lender on the old loan. *Nat Harrison Associates, Inc.*, 42 T.C. 601 (1964); *Estel L. Cheeseman*, T.C. Memo par. 69, 259 (1969); *Cleaver* v. *Comm'r.*, 158 F.2d 342 (7th Cir. 1946).

Nor can a taxpayer give his own note in payment of his interest liability; the note is not the equivalent of cash so as to entitle the taxpayer to a deduction. *Helvering* v. *Price*, 309 U.S. 409 (1940).

Also, increasing the principal of a loan by the amount of interest owed does not constitute a "payment" for a cash basis taxpayer. *James England*, 34 T.C. 617 (1960); *Keith* v. *Comm'r.*, 139 F.2d 596 (2d Cir. 1944).

Nevertheless, the Tax Court has carved out an exception to the general rule against allowance of taxpayer-debtor interest deduction when the debtor borrows a second time from the same creditor to make interest payments on the initial loan. That exception is the progency of the cases, *Burgess* and *Burck*.

Turning now to the Battelsteins, the Government cites several authorities for its position and argues that the Battelsteins' cases are only a variation of the loan discount plans negated in many cases. However, the *Burgess* and *Burck* decisions make it clear that the facts of the transactions should be determinative.

The Government contends that the *Burgess* case holding has been criticized. Nevertheless, that criticism has not convinced the Tax Court to hold against a taxpayer involved in this type of transaction. Subsequent to the dictum disapproval, the tax court passed up an opportunity to alter its position when it decided the *Burck* case. Therefore, in the opinion of this court, the prevailing view is that found in *Burgess* and *Burck*.

The Government produced exhibits in an attempt to show debtors' inability to pay the interest and taxes plus their other bills, but the debtors successfully rebutted this with a showing that they had ample resources with which to pay all their bills. The debtors testified that they had large

checking account balances at the time the loans were made, that they could have acquired loans through other sources and that their other substantial assets were available to pay the expenses if needed. Although those assets were not always in the form of cash in their bank accounts, in the opinion of the court, the fact that the debtors could have paid the bills without the loan funds is a consideration favorable to the debtors.

The Battelsteins' transactions with Gibraltar, met the *Burgess/Burck* test for allowance of the interest deductions. The Battelsteins' commingled the loan funds with funds in their regular bank accounts and the funds lost their identity, the expenses were paid by check, and the debtors had adequate resources with which to pay their bills even without the loan funds. Therefore, the transactions should be treated as cash payments.

Also, the transactions meet the *Goldstein* requirement that there be "economic utility" in the transactions beyond an attempt to acquire an interest deduction for tax purposes. The Battelsteins and the Association explained the business purpose of the transaction was to enable the owners of the Sharpstown property to maintain ownership of the Property for an extended period of time, and to make improvements, including the addition of utilities. Under the agreement, the Association received first, repayment for all loans made and interest on those loans plus 19% of all remaining proceeds after the expenses of any sale of the property. Under these facts, there was clearly no sham business deal conceived solely to render the debtors a tax deduction.

Based on the facts involved in this case, it is the opinion of the court that the cases cited by the Government do not reach the issues. The Government cites *Goldstein* v. *Comm'r.*, 267 F.2d 127 (1st Cir. 1959), in which the Cir-

cuit Court found that there was no indebtedness. The *Goldstein* court decided that whatever relationship existed between the parties it was not debtor-creditor but was akin to the exchange of promises of future performances between taxpayer and lender. *Id.* at 131. Furthermore, the court found that the only purpose of the transaction in that case was to achieve interest deductions.

In contrast, the Battelsteins clearly showed "economic utility" in the transactions which reach beyond an interest deduction. Also, there is no finding that a debtor-creditor relationship did not exist between the Battelsteins and the Association.

The Government also cites the case of *Parks* v. *United States,* 77-1 U.S.T.C., par. 9404 (N.D. Tex., April 18, 1977), which also misses the mark. The case dealt with prepayment of interest which the court decided should be amortized over a period of interim construction financing The arrangement in that case involved payment of the interest out of the initial loan proceeds; whereas the Battelsteins' arrangement involved their reimbursement by the Association in a series of separate new loan transactions as the interest and tax expenses became due.

On the point of the ad valorem tax expenses, the basis for that deduction is the Internal Revenue Code § 164(a)-(1), 26 U.S.C. § 164(a)(1), which provides:

> "Exept as otherwise provided in this section, the following taxes shall be allowed as a deduction for the taxable year within which paid or accrued:
>
> (1) State and local . . . real property taxes. . ."

The debtors support their deductions with a series of cases including *Hazel McAdams,* 15 T.C. 235 (1950) and *Robert B. Keenan,* 20 B.T.A. 998 (1930). In the opinion of this court, these authorities entitle the debtors to their

claimed deductions for tax expenses in the years paid despite payment of the taxes with borrowed funds.

For all the reasons hereinabove set forth, I find that the debtor Barry L. Battelstein is entitled to the interest and tax expense deductions claimed for the year 1973 provided, however, Barry Battelstein has conceded a tax deficiency of $25,074 consisting of $21,574 by way of an increase in the 1974 dividend income and a disallowance of 1973 partnership allowance, plus a $3,500 adjustment in depreciation on apartments which was conceded at the trial. I find that debtor Jerry E. Battelstein is entitled to the interest and tax expense deductions claimed for the years 1973 and 1974.

The debtors' requests for recovery of reasonable attorney's fees incurred in prosecuting this objection to claim is denied. In the opinion of the Court 42 U.S.C. § 1988, on which debtors base their request, is not applicable to the facts of these cases.

Counsel for the debtors shall submit the appropriate order.

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WILLIAM M. SCHULTZ
United States
Bankruptcy Judge

No. 80-1468

APR 2 19
CLERK

In the Supreme Court of the United States

OCTOBER TERM, 1980

BARRY L. BATTELSTEIN AND JERRY E. BATTELSTEIN,
PETITIONERS

v.

INTERNAL REVENUE SERVICE

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE FIFTH CIRCUIT

MEMORANDUM FOR THE RESPONDENT IN OPPOSITION

WADE H. MCCREE, JR.
Solicitor General
Department of Justice
Washington, D.C. 20530
(202) 633-2217

TABLE OF AUTHORITIES

Page

Cases:

Beck v. *Commissioner*, 45 T.C. 1534 6

Brown v. *United States*, 396 F. 2d 459 4-5

Burck v. *Commissioner*, 533 F. 2d 768, aff'd, 63 T.C. 556 5

Burgess v. *Commissioner*, 8 T.C. 47 ..... 5, 6, 7

Cleaver v. *Commissioner*, 6 T.C. 452, aff'd, 158 F. 2d 342, cert. denied, 330 U.S. 849 3

Don E. Williams Co. v. *Commissioner*, 429 U.S. 569 3

England v. *Commissioner*, 34 T.C. 617 3

Goodstein v. *Commissioner*, 267 F. 2d 127, aff'g, 30 T.C. 1178 ..... 4, 7

Gregory v. *Helvering*, 293 U.S. 465 4

Hart v. *Commissioner*, 54 F. 2d 848 3

Helvering v. *Price*, 309 U.S. 409 3

Hoboken Land & Improvement Co. v. *Commissioner*, 138 F. 2d 104 4

Hopkins v. *Commissioner*, 15 T.C. 160 3

Johnson v. *Commissioner*, 86 F. 2d 710 4

Keith v. *Commissioner*, 139 F. 2d 596 3

Lynch v. *Commissioner*, 273 F. 2d 867 4

Miles v. *Livingstone*, 301 F. 2d 99 5

Minnesota Tea Co. v. *Helvering*, 302 U.S. 609 5

Page

Cases—Continued:

Nat Harrison Associates, Inc. v. *Commissioner*, 42 T.C. 601 3

Rubnitz v. *Commissioner*, 67 T.C. 621 3

Wilkerson v. *Commissioner*, 70 T.C. 240 5

Statute:

Internal Revenue Code of 1954 (26 U.S.C.):

Section 163 ..... 1, 2
Section 163(a) 6
Section 446 6

In the Supreme Court of the United States

OCTOBER TERM, 1980

No. 80-1468

BARRY L. BATTELSTEIN AND JERRY E. BATTELSTEIN, PETITIONERS

v.

INTERNAL REVENUE SERVICE

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE FIFTH CIRCUIT

MEMORANDUM FOR THE RESPONDENT IN OPPOSITION

The question presented in this factual income tax case is whether the giving of a borrower's note for the amount of interest due on a prior loan, simply because it is accompanied by a prearranged exchange of offsetting checks between debtor and creditor, amounts to payment of interest so as to be deductible by cash basis taxpayers under Section 163 of the Internal Revenue Code of 1954 (26 U.S.C.).

The pertinent facts may be summarized as follows: Petitioners were land developers who reported their income for tax purposes on the cash receipts and disbursements method of accounting. In 1971, Gibraltar Savings Association agreed to lend petitioner more than three million dollars for the purchase of a piece of property. Gibraltar also agreed to make further loans in the future to cover costs of

holding the property, including interest payments on the original loan. In partial consideration for its participation, Gibraltar was to receive 19% of the profit from the sale of the property (Pet. App. A-3, A-17 n.1).

Pursuant to this agreement, Gibraltar notified petitioners of the current interest due each quarter. Petitioners then sent Gibraltar a check for that amount and Gibraltar, in turn, sent petitioners its own check in the identical amount (Pet. App. A-3). Petitioners executed notes for each of the additional loans (Pet. App. A-3 to A-4). Petitioners claimed interest deductions for 1973 and 1974 on the ground that these checks to Gibraltar constituted payments of interest under Section 163.[1] In 1976 and 1977, petitioners filed Chapter XI petitions in bankruptcy. The Internal Revenue Service filed claims against each petitioner based, in part, on the Commissioner's disallowance of these interest deductions (Pet. App. A-33 to A-34). The bankruptcy court upheld petitioners' right to the interest deductions on its findings that Gibraltar had no control over the funds advanced to petitioners (Pet. App. A-35); that petitioners had other funds with which they could have paid the interest liability (Pet. App. A-38 to A-39); that the funds advanced to petitioners were commingled with other funds in petitioners' bank accounts (Pet. App. A-39); and that the underlying transaction had "economic utility" (*ibid.*). The district court affirmed (Pet. App. A-29).

The court of appeals, after rehearing en banc, reversed. It concluded that despite the exchange of checks, which resulted in petitioners' satisfying their interest obligations, "[t]he law leaves no doubt that such a surrender of notes

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[1] Barry Battlestein capitalized his portion of the interest for 1974 (Pet. App. A-25).

does not constitute payment for tax purposes entitling a taxpayer to a deduction" (Pet. App. A-5).[2]

1. The decision below correctly held that petitioners were not entitled to a deduction for interest paid with notes. This Court has long held, and has recently reaffirmed, that giving a note is not such payment by a cash basis taxpayer as to give rise to a deduction against gross income. *Don E. Williams Co.* v. *Commissioner*, 429 U.S. 569 (1977); *Helvering* v. *Price*, 309 U.S. 409 (1940). "The reasoning is apparent: the note may never be paid, and if it is not paid, 'the taxpayer has parted with nothing more than his promise to pay.' " *Don E. Williams Co., supra*, 429 U.S. at 578, citing *Hart* v. *Commissioner*, 54 F. 2d 848, 852 (1st Cir. 1932). This rule has been broadly applied to transactions that, in substance, result in a taxpayer's giving his note in lieu of a cash payment of interest, whether by discounting the original loan, *Rubnitz* v. *Commissioner*, 67 T.C. 621 (1977); *Hopkins* v. *Commissioner*, 15 T.C. 160 (1950); *Cleaver* v. *Commissioner*, 6 T.C. 452, aff'd, 158 F. 2d 342 (7th Cir. 1946), cert. denied, 330 U.S. 849 (1947); by increasing the principal of a loan by the amount of interest currently due on the loan, *England* v. *Commissioner*, 34 T.C. 617 (1960); or by withholding the interest due on a previous loan from the same lender, *Keith* v. *Commissioner*, 139 F. 2d 596 (2d Cir. 1944); *Nat Harrison Associates, Inc.* v. *Commissioner*, 42 T.C. 601 (1964).

Petitioners lose sight of the fact that, with the exception of their reliance upon the exchange of checks, all of their arguments are nothing more than an attack upon the rule established by this Court in *Helvering* v. *Price*, *supra*, and *Don E. Williams Co.* v. *Commissioner*, *supra*. Thus, for

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[2]The original panel of the Fifth Circuit had reversed the district court on substantially the same ground (see Pet. App. A-20).

example, petitioners argue (Pet. 7) that the source of borrowed funds used to pay a debt is not relevant, and (Pet. 10-12) that the holding below will impede and discourage commerce. But if petitioners were to prevail here, the rule announced by this Court would be emasculated because any taxpayer wishing to defer payment of a debt and still obtain a tax deduction for interest could readily arrange for the meaningless exchange of checks that occurred in this case.

2. Petitioners further argue (Pet. 5-7) that the court of appeals created an unwarranted exception to the general rule that payment by check is equivalent to payment by cash for tax purposes. This is clearly not the case. Petitioners issued their checks to Gibraltar pursuant to an agreement whereby Gibraltar would return to them checks in identical amounts. In ignoring this exchange for tax purposes, the court of appeals was not holding that checks are not cash equivalents for tax accounting purposes. To the contrary, it concluded that the checks were irrelevant to the transaction. In so ruling, the court applied the principle announced by this Court in *Gregory* v. *Helvering*, 293 U.S. 465 (1935), that a form or device that is devoid of economic substance may be disregarded for tax purposes.[3]

Exchanges of offsetting paper have been disregarded as merely paper transactions in a number of contexts. See, *e.g.*, *Hoboken Land & Improvement Co.* v. *Commissioner*, 138 F. 2d 104, 109-111 (3d Cir. 1943); *Johnson* v. *Commissioner*, 86 F. 2d 710 (2d Cir. 1936). And they have frequently resulted in the denial of interest deductions. See, *e.g.*, *Goodstein* v. *Commissioner*, 267 F. 2d 127 (1st Cir. 1959); *Lynch* v. *Commissioner*, 273 F. 2d 867, 869 (2d Cir. 1959);

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[3]At all events, the decision below does not rest upon a distinction between a tender of a check and a tender of cash. An exchange of actual cash with the lender, in lieu of the exchange of checks, would likewise be disregarded and would not entitle petitioners to a deduction.

Brown v. *United States*, 396 F. 2d 459 (Ct. Cl. 1968), and the many cases cited therein. Cf. *Miles* v. *Livingstone*, 301 F. 2d 99 (1st Cir. 1962). The exchange of offsetting checks in the instant case was properly ignored for tax purposes. As this Court observed in *Minnesota Tea Co.* v. *Helvering*, 302 U.S. 609, 613 (1938), "[a] given result at the end of a straight path is not made a different result because reached by following a devious path."

Here, petitioners and Gibraltar trod no path, straight or circuitous. They remained where they were. Petitioners' debts, for principal and for interest, were the same before and after their exchanges of checks, and interest deductions were properly denied. Petitioners contend (Pet. 10-12) that the court of appeals' decision would create commercial uncertainty and impede commerce. But the court of appeals' rejection of meaningless paper shuffles will surely not impede bona fide commercial activity. Indeed, petitioners themselves concede (Pet. 10-11) that a sham transaction may be disregarded for tax purposes.[4]

3. Petitioners also contend (Pet. 4) that the decision below conflicts with *Burck* v. *Commissioner*, 533 F. 2d 768 (2d Cir. 1976), aff'd, 63 T.C. 556 (1975), as well as with *Burgess* v. *Commissioner*, 8 T.C. 47 (1947), and *Wilkerson* v. *Commissioner*, 70 T.C. 240 (1978), appeal pending, No.

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[4]The bankruptcy court's determination (Pet. App. A-39) that the underlying transaction had "economic utility" is beside the point. There may have been a valid loan, but no economic purpose was ever found for the exchange of checks that purportedly paid the interest. The argument of the dissenting opinion in the court of appeals (Pet. App. A-11) that the loans had a business purpose is similarly inapposite. It is the exchange of checks that is meaningless and was properly ignored by the majority—not the underlying loan. Indeed, the transactions in *Price* and *Williams*, had the same economic utility claimed by petitioners—they enabled the taxpayers to retain cash which would otherwise have passed to the lender and to use that cash for other bona fide commercial purposes.

79-7519 (9th Cir.). But the dictum in *Burck* actually supports the decision below. In *Burck*, the taxpayer borrowed $3,000,000 from the Bank of Commonwealth, $1,000,000 of which was transferred by wire to taxpayer's account with First National City Bank. On the next day, the taxpayer transferred $377,000 back to Commonwealth as prepayment of interest on the $3,000,000 loan and on another loan that taxpayer had taken from Commonwealth. The Tax Court, citing its earlier decision in *Burgess* v. *Commissioner, supra*, sustained the theoretical correctness of the taxpayer's interest deduction because the proceeds of the second loan were commingled with other funds and thus were not directly traceable to the interest payment. The court further relied on its findings that taxpayer possessed substantial other assets with which he could have paid the interest (63 T.C. at 560).

The Tax Court also held, however, that only 3/365 of the interest was allowable in the year in issue, because the remainder was prepaid interest that materially distorted the taxpayer's income and was properly disallowed by the Commissioner under Section 446 of the Code. The taxpayer's appeal in *Burck* was limited to this second issue. The majority opinion of the Second Circuit, which ruled in favor of the Commissioner on the Section 446 issue, also stated in dictum that the Tax Court's treatment of the Section 163(a) issue was incorrect. Thus, contrary to petitioners' representation (Pet. 4-5), to the extent that the Second Circuit addressed the issue at all, its opinion supports, rather than conflicts with, the decision below. Indeed, in a subsequent citation to *Burck* in support of the *Burgess* rule (Pet. 8), petitioners concede that *Burck* was affirmed on other grounds.

Moreover, the Tax Court's reasoning in this line of cases is unsound and contrary to the teaching of this Court in *Price* and *Williams*. The Tax Court itself has taken note

that *Burgess* "has been the subject of some criticism." *Beck* v. *Commissioner*, 45 T.C. 1534, 1565 (1980). It has never been approved by any appellate court. In addition to the decision below and the dictum of the Second Circuit in *Burck*, the First Circuit in *Goodstein* v. *Commissioner*, 267 F. 2d 127 (1959), aff'g 30 T.C. 1178 (1958),[5] expressly approved the position of the dissenting judges in *Burgess*, who concluded that the exchange of checks in that case was a nullity and that the transaction was governed by the general rule that a cash basis taxpayer who pays interest on a debt with funds borrowed from the same creditor has not made a cash payment of interest which is deductible from gross income (8 T.C. at 51). In sum, *Burgess* and its progeny have been universally disapproved by the courts of appeals.

It is therefore respectfully submitted that the petition for a writ of certiorari should be denied.

WADE H. MCCREE, JR.
Solicitor General

APRIL 1981

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[5]The Tax Court in *Goodstein* noted, without discussion, that *Burgess* was distinguishable on its facts (30 T.C. at 1192).